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DISCUSSION

ON PAPER BY H. C. ADAMS ON TENDENCIES IN RAILWAY
TAXATION

WILLIAM W. BALDWIN : It is claimed by many to be the law that investments in railroads are no longer to be regarded as private property for the purposes of profit.

The merchant, the manufacturer, the banker, the farmer, the miller, the ship owner may derive whatever profit he can from the lawful use of his property and talents, taking the risk of loss ; but it is said that the investor in a steam railroad is limited to what is called a fair return upon the value of the property used, which being calculated, is held to mean a return based upon the lowest generally prevailing rates of interest, and without guaranty of any return, and notwithstanding he takes the risk of loss, and often loses. If returns show a larger profit, demand is frequently made that the state reduce the rates, that is, the price a railroad may charge for the service rendered ; and, the property being held to be public property, because employed in the business of carrying for the public, the state does reduce the rates.

Now, this status of railroad property, this limitation by law of its earning capacity, should, it seems to me, be taken into consideration by economists in framing laws for its taxation, especially if such laws have a social object. Professor Seligman says that taxation may be utilized for social purposes, and speaks of socialists,—extreme socialists he calls them,—represented in academic circles in this country, who maintain that the social problem is the great problem, and that a tax is not a tax, unless it has a social object, as distinguished from

a fiscal object. In a sense, of course, all taxes are collected for social objects, but in this connection is meant the distinctly socialistic purpose of appropriating, through taxation, as distinguished from the exaction of an equal contribution in proportion to value to meet the fiscal needs of the state.

Are we entering upon a period of such social taxation, or appropriation of railroad property? Are we to have a system of tax laws applicable to railroads only, and based upon the view, that this one class of property in this country has no moral right to earn more than a specified rate of interest or return upon its cost, without guaranty of any return, and that if a railroad shows a surplus, beyond a specified rate, such surplus may be, and ought to be, reached through the taxing power?

Treating railroads as quasi-public property, and restricting their right to surplus earnings through reduction of rates is subject to this powerful limitation which the courts have inserted—that they shall be permitted to earn *some* return upon the investment. But no such limitation will, it seems, be written, even by the courts, into a tax law. The taxing power is practically without limit. The power to tax is the power to destroy. Does the suggestion not appeal to economists who are not socialists, that it is going a step too far to devise taxation as a means of reaching surplus, exclusively for this form of property, now so largely held for investment? It is true that, during the past five year period, railroads have been prosperous, but not more so than many other lines of business; and in the previous five year period, they saw much of adversity, and entire investments were wiped out, which fact cannot be and will not be taken account of in fixing the rate they should now be permitted to earn. Those who are fa-

miliar with the subject of railroad taxation know the practical impossibility of reducing the tax, in the face of public opinion, whatever depressions in business may be experienced ; hence the greater care should be exercised in adopting a policy intended to reach present surplus railroad income through taxation.

TAXES SHOULD BE UNIFORM

That taxes, the means of supporting the government, should be levied with equality, and their burden rest uniformly upon all subjects on which they are laid, is a correct principle, in economics, as well as imbedded in the constitutions of the states. Over and again courts have said, that "A sound tax law must equally distribute its burden among the citizens according to their property."

What reasons, then, are urged for applying exclusively to railroad property a tax system, based upon reaching their surplus earnings, after allowing a rate of return upon property deemed to be socially or ethically sufficient, while no attempt is made to reach the surplus of other citizens and their property by similar methods? In prosperous times, many, if not most, lines of business show surplus income. What economic reasons are given for applying these methods to railroads only?

It is said that the railroad is a peculiar property, and the peculiarity is that commercial forces fail to dissipate its surplus earnings ; which is only another way of saying that its surplus is more permanent or more to be depended upon than is seen in other industries.

Also, that because the state requires complete reports from railroad companies, the amount of their surplus is more easy of ascertainment.

The first reason does not appear to be borne out by experience. The profits of railroads seem to fluctuate with good and bad times and conditions as much as do those of other industries as a class; and their surplus is as quickly dissipated by the blasts of adversity. The average net earnings per mile of the Burlington road for the four years prior to the year 1887 were \$3,420, while the average for the succeeding four years were \$1,618 per mile, one of the consequences of the enactment of the Inter-State Commerce law, and of a strike of locomotive engineers, which may occur to any railroad. At the mercy of the legislature and the commission in the matter of rates, and of the labor union in the matter of wages, no class of property, it seems, must fight harder to prevent the dissipation of its earnings, than that owned by railroad companies.

Another answer is that, if the railroad industry is to be, in effect, subjected to an income tax, some endeavor should at least be made to apply similar methods to other industries; and then, whether their income proves to be temporary or permanent in character, the test will will be the same. Regarding the matter of reports, the answer is—get the reports; require other industries, as well as railroads, to furnish them; make some honest effort to lay the income tax upon other industries.

Another reason is based upon an assumption that really goes to the root of the whole matter, namely, that other industries and property are, in effect, taxed in proportion to income, through assessments of value, fixed from frequency of sales, while, in the case of railroads, no such sales can guide the assessor, and therefore a method of assessment through income must be devised.

The assumption is not founded upon fact. Other property is not taxed in proportion to income through

the sales test; it is not assessed at its value by any test. The State Board of Assessors of Michigan announced their finding, that the true value of the general property in that state for the year 1902 was \$1,715,000,000. The assessment in fact of the same property for the same year was \$1,418,251,858, a difference of more than twenty per cent. There is hardly a doubt that, if the investigation of the State Board of Assessors had been thorough, and especially if the assessments upon the general property had been levied upon any basis of income, the disparity would have reached fifty per cent.

THE MICHIGAN PLAN.—AN INCOME TAX.

But, notwithstanding the apparent lack of adequate reasons, there is now in operation in the state of Michigan, unless the courts forbid, a plan for the taxation of the railroads of that state largely upon the basis of income, which is dependent for its results upon the social view that railroads are entitled to earn only a certain designated amount.

It is suggested that the Michigan legislature adopted this so-called *ad valorem* tax law for railroads upon proof that under the gross earnings tax system they were paying less taxes in proportion to the true value of their property than the general property of the state. But this point loses force when it is known that this proof consisted of nothing more nor less than theoretical deductions and conclusions of value previously worked out by capitalizing income at certain low percentages, by the very same experts.

That it amounts to a capitalization of good will, under the names of "organization" and "vitality" and "franchise," and is in effect an income tax, administered with

the social purpose of restricting income through taxation, seems clear enough from the following report of the evidence of Professor Adams. The question was asked :

“ Now, what is the difference between this net earnings theory of valuation for the purpose of arriving at the tax and an income tax upon the net income? I mean, not in appearance but in fact.”

Ans. “ You have reference to the capitalization of the net earnings direct at a single rate and for a single year? ”

Q. “ Yes sir.”

A. “ I don't think there is any difference except the formal difference that in one case the tax is levied upon a valuation discovered from the earnings and in the other case it is levied directly upon the earnings; the amount to be paid, other things being equal, would of course be the same.”

Q. “ So that practically it is a tax based upon the income, isn't it, and not upon a valuation of the property? ”

A. “ The tax levied upon the capitalization of net earnings year by year would amount to a tax levied upon the earnings themselves, yes sir.”

Q. “ The only difference in form is that you capitalize the earnings before you apply the tax, instead of putting it directly upon the earnings? ”

A. “ Yes sir.”

Q. “ That is to say, that, when applied to the capitalization, the tax appears to be lower than when applied directly to the income? ”

A. “ Yes sir.”

The fact of applying this process year by year, or every five years, upon the average of the earnings each

year for five years, seems to be a distinction without a difference. Indeed, Professor Adams stated in his evidence that the adoption of an average of net earnings over a period of five years was not prescribed in the law, but he added : "In order that the law may be administered as an *ad valorem* tax, and not as an income tax, this method does take a period of years." That is equivalent to saying that it was a mere device to save the face of the law and have that pass for an *ad valorem* statute which is, in fact, an income tax.

PRACTICAL APPLICATION OF METHOD.

The method of administering this process shows that it is really an income tax, the size of which is determined, not by the law, but by the expert's opinion of what rate of return he thinks the owners ought to be satisfied with, taking into consideration the prevailing price of first mortgage railroad bonds, and other evidence. The rate decided upon for the Michigan Central was three and one-half per cent., and the method pursued, as I understand it, was this :

The net income of that company for Michigan was said to be \$2,503,345. This income was divided into two parts. The greater part (\$1,590,352) was capitalized at 3½ per cent., as in his opinion this particular company should be content with that rate of return upon its capital to the extent of \$43,438,599, because that sum represents the estimated cost of reproduction in present form, of all its property as determined by expert engineer Cooley and his investigations.

The remainder of income (\$913,000) was then capitalized at 5 per cent., producing \$18,259,880, which being added to the property value produces \$63,698,479 as a tax valuation recommended to the State Board. Upon

this theorized valuation there was to be levied, not the tax rate to be paid by other property in Michigan in proportion to value, but substantially double such rate. The rate, in fact, levied on all railroads was over sixteen and one-half mills on the dollar. Professor Adams expressed the opinion that the property in fact assessed in Michigan was assessed at 65 per cent. of value, and deduced therefrom the conclusion that the true average rate of taxation was ten mills; yet this railroad property, being first given an exaggerated valuation, then had levied upon it a rate of sixteen and one-half mills.

I will read from page 55 of the Report of the Michigan Board of State Tax Commissioners for 1902, their statement of the method:

"The investigations pursued by Professor Adams covered the economic side of the question of railroad valuation. He took the gross earnings of the various companies and averaged them for periods ranging from four to ten years. The same average was taken in the case of operating expenses, and the difference between the two produced the average earnings from operation. To this sum was added the net income from investments, and the result obtained was called the 'total available corporate income'. From this result three items were deducted, namely, 'rents of Michigan property not included in Cooley Appraisal', 'Interest on interest bearing current liabilities' and 'Permanent improvements in Michigan charged to income'. This process of calculation resulted in either a 'surplus from operation' or 'deficit from operation'. The 'mean value of physical elements', computed from the Cooley Appraisal, was a figure obtained to correspond to the average amount of physical property in use by the railroad company during the period of years for which the

average of gross earnings and operating expenses was taken. On this mean valuation a tax of one per cent. plus an annuity of four per cent. was computed, and the sum of such tax and annuity deducted from the 'surplus from operation', resulting in either a 'net corporate surplus' or deficit. This difference or net corporate surplus was then capitalized at various rates in the case of different properties, ranging from four to ten per cent. according to the security of the business of the specific company under investigation."

This indicates that the basis of the State Board's valuation and assessment was largely the capitalization of income upon the theories proposed; that it rested upon income averages furnished by Professor Adams, running from four to ten years, and upon widely differing rates of capitalization upon income, also furnished by him, and depending upon his opinion of what years to take, and what rates of capitalization to apply, ranging from three and one-half to ten per cent., according to his view of what the owners of the various classes of railway property in that state ought to be satisfied with, or what the social good requires them to accept.

But these theories are only applied to roads whose operations show a surplus. If there is no surplus to be reached, another method attaches. Measured by income, a road whose operating expenses consume all its income in fact possesses only a nominal value. But, in dealing with that class of railroads, the State Board in Michigan, to a large extent, ignores the matter of income. In such cases, the estimate of the engineering expert controls, based upon cost of materials and labor. The Board says in effect, "There is the property and if the owner was improvident in locating his property, and is conducting his business as a public benefit, without reward, although

involuntarily, that is no concern of ours; our duty is to assess 'property' in his case."

Of date, April, 1903, the State Board placed a valuation of \$55,500,000, or \$55,000 per mile, upon the Michigan Central, which the engineering expert had valued at \$32,000 per mile.

The North-Western line (521 miles) with virtually no income was valued at \$27,000 per mile, because, and only because, that was the engineer's estimate. Although valued upon radically different theories the same rate of tax (16½ mills) is levied upon both of these roads.

In 1902, the net earnings of the North-Western road in Michigan were \$445 per mile; and the taxes levied by the State Board were \$468 per mile; in 1903, the earnings were \$568 and the taxes \$454. These were both years of unusual prosperity. When the adverse period comes, the taxes will remain but the earnings will vanish. Are they having in Michigan a lesson in the problem of how to utilize railroad taxation for social objects?

THEORY OF NON-PHYSICAL VALUE.

One cannot fail to be interested in the argument by which income seems to be made to perform duty as being or representing an "immaterial" or theoretical property element, supposed to inhere peculiarly in a railroad. The Michigan law is an *ad valorem* law, which renders it necessary to define the elements of this immateriality; and they are accordingly defined in the letter of Professor Adams to the State Board of Tax Commissioners, dated October 4, 1900, as "franchise," as "the possession of local traffic," as "the possession of traffic held by established connections," as "the benefit of economies made possible by density of traffic," and "the fact of or-

ganization and vitality existing not only in the railroad but in other industries which it serves."

He was asked this question: "In the final result, does it make any difference what the elements of the non-physical property consist of?"

Ans. "Not according to this rule."

Q. "You named some of the elements. Now strike out every one of those elements except one, and would not the result be exactly the same as if they are all considered?"

A. "The result in figures would be the same."

In amplifying this view of certain non-physical elements as being "property" of a railroad which ought to be taxed, Professor Adams said: "A railroad is more valuable which runs through a territory full of bright, energetic people;" also that "intelligence, sobriety and willingness on the part of laborers to submit themselves to discipline are conditions under which industries exist and which make them succeed; that "the railroads of the North are more valuable than those of the South, on account of the nature of the employees and the people;" and, while discussing the question of "organization" and "vitality" as taxable elements, he said: "If the schools of Michigan were disorganized for a generation. the railroads would not be worth very much."

Other features and conditions, almost without limit, could, of course, be named which potentially affect the earnings and incidentally the value of railroads, such, notably, as the character of their traffic, and, above all other influences, the ability of their managers and the extent to which they can secure remunerative rates for their business; but who will capitalize these elements?

I do not understand that Professor Adams has made an estimate of values for "traffic density," nor for "or-

ganization," nor again for "vitality," any more than an estimate of value for the presence and efficiency of the Michigan schools. Why? Because they are, one and all, simply features of the good-will of a railroad, in the same way that similar features constitute the good-will of any business. The only means of valuing then suggested is by capitalizing earnings; and, in its results and effects, it is an income tax, pure and simple, and it only confuses the subject to pretend otherwise.

There is no income tax in Michigan, and no evidence that any other class of property in that state is taxed upon its good-will, as such.

AD VALOREM LAW NOT AN INCOME TAX.

Economists say that the fundamental idea of an *ad valorem* tax law is, that it rests upon property, without regard to ownership or the proportion of protection furnished, and without regard to the ability of the owner to pay a uniform rate to be levied upon all property in proportion to its value.

An income tax, on the other hand, rests entirely upon ability to pay, as measured by income. When the income is derived from property it is taxed regardless of the value of the property itself. Vacant land, however valuable, produces nothing to the income tax, while property, such as a telephone system, having small value apart from its peculiar use, may show large receipts which an income tax would reach. Governments decide which system, the property tax or the income tax, is, on the whole, best suited to their condition and necessities, and it is easily conceivable, may adopt a system combining the two, that is, for taxing the land and all interests in land, and all tangible personalty, according to value, and likewise, taxing all incomes, with ade-

quate provision against double taxation, that is, that no property which has paid the *ad valorem* tax shall in addition pay an income tax.

Such an income tax law would be carefully drawn, and all interests be guarded so as to ensure equality and uniformity between tax payers. But that is a totally different affair from an income tax administered as an *ad valorem* law, or an *ad valorem* law administered as an income tax. In the first case, income might be determined, not from actual receipts, but from expert calculations of what income ought to be produced from property having a certain estimated value. In the second case, value is determined from income capitalized. Still different is an *ad valorem* law administered with a social purpose, that is, through the selection of a certain class of property, and limiting all property in that class possessing income to a percentage return deemed socially sufficient, and capitalizing such property upon that percentage, while all other property in the class is valued at cost of reproduction in present form, without regard to income?

A well-known economist recently made a public plea, on moral grounds, for taxing railroads and similar public service corporations by some mathematical rule that will eliminate the necessity for the exercise of discretion by assessors, saying that "opportunity for bribery gives equal opportunity for blackmail."

Anyone who will master the process of making a valuation of the different Michigan railroads under the so-called *ad valorem* system, as administered in that state, will find an amount of discretion, and an assortment of various kinds of discretion, that seems to be without parallel.

RESULT IS EXCESSIVE TAXATION.

That the installation of this method in Michigan, if approved by the courts, will result in excessive taxation of railroads, compared with other property, goes without saying.

Judge Grosscup deemed the capitalizing of the earnings of a street railway as a measure of the value of its franchise, consisting, as it does, in the monopoly of the streets of a great city, at the rate of six per cent, to be a fair rate, considering the risks and the necessities for renewals, etc.

A commission of well-known experts, asked recently to find the proper scientific basis for compensating parties contracting with the government for pneumatic tube service, in order to allow investors a fair return, reported as follows :

“That the investors be entitled to a return on their investment, over and above operation and ordinary repairs and maintenance, as follows :

	Per ct.
1. Interest on the actual cash investment.....	4
2. Additional profit on the actual investment, in order to compensate for risks, necessary in order to induce investments, 3 to 6	
3. Renewal fund, to be set aside for replacement of the property in 20 years.....	3.23
4. To pay taxes of all kinds.....	I
Maximum total	14.23
Minimum total	11.23

This amounts to saying that an investor, putting cash into a public utility plant, should have, as compensation, if his plant be of a sort that it may quickly be worn out, or become obsolete by reason of new inventions, or other displacement, of 14.23 per cent.

If the plant be of an enduring character, as for example, a masonry dam, in the case of water works on a site

that is owned in fee, the risk of deterioration diminishes; and the total return which the investor may require is reduced to 11.23 per cent.

Such percentages, applied to the income of Michigan railroads, would manifestly produce a radically different valuation of those roads which have a surplus, from that announced.

Capitalization of the \$2,500,000 net earnings of the Michigan Central Company on the Grosscup plan would show a valuation of \$41,666,000, instead of the \$63,698,479 upon the same property and the same income, as proposed by Professor Adams.

Professor Emory Johnson, after full consideration of Professor Adams' method, stated in evidence that, in his opinion, a correct application of that method to the Michigan Central would take the average of net earnings for a ten year period, and deduct therefrom 6 $\frac{2}{10}$ per cent. on the valuation of the physical property, and capitalize the net corporate surplus remaining at 6 per cent., plus the tax rate. Computed thus, the value of the "franchise" of the Michigan Central was found to be \$3,227,000, as compared with the valuation by Professor Adams of the same franchise for the same year at \$18,259,880.

Shall the amount of taxes which the railroad company must pay depend less upon its actual value and its actual income, than upon the question of what expert is employed to fix the percentages and to make the calculations?

Differences of opinion as to value in the Michigan estimates were, by no means, confined to the franchise feature. In the case of the Pere Marquette Railroad, for instance, the engineer employed by the State Board found a present value, based upon cost of reproduction,

of nineteen million dollars, while another equally competent engineer, representing the railroad company, determined the value of the identical property to be eleven million dollars.

QUESTION OF RATE AS IMPORTANT AS QUESTION OF
VALUATION

But the question of valuations is, after all, only a part of the problem. If, in fact, the rate of tax laid upon the real value of other property in Michigan is ten mills on the dollar, or less, why should railroad property, upon any method or by any system, be required to pay a rate of sixteen and one-half mills? No consideration of the so-called Michigan plan can be adequate which ignores this feature of the case. Economists apparently devote themselves to the question of devising theories for securing a complete financial estimate of all the features of a railroad, when the question which might well engage their attention in this connection is, what part of this value shall be subjected to taxation, in placing the tax burden upon this class of property, the same as it in fact, rests upon other property, in proportion to value?

Professor Meyer says that a railroad is worth what it can earn. Professor Seligman thinks that taxation of net receipts is a more equitable system of taxation than any other, and, speaking of the operation of the Ford, bill in New York, says that its object is to hit the difference between the value of the tangible property and the total value of the corporation, or the good-will of the business. Professor Adams' paper read to-day is devoted largely to showing that there exists a peculiar element of value in railway property, that may be reached for taxation by widening the jurisdiction of the general

property tax, so as to reach this peculiar value, meaning the value of the business as a going concern.

The North-Western Railway, meanwhile, in the state of Michigan, with no change in its property and no addition to its earnings, finds its tax bill in the first year of this widening of the jurisdiction of the general property tax, leaping from \$78,000 to \$234,000, and the proportion of tax to net receipts reaching a modest one hundred and five per cent.

It will not do to say that economists are not concerned whether railroads are compelled to pay more than an equal share of the taxes of the state, in proportion to the value of their property, compared with all the other property. That is the very question about which they ought to be concerned. The aggregate assessment made by local assessors upon the real and personal property in the Michigan counties in which the North-Western road is situated, is below fifty per cent. of the true aggregate of such property, and the rate levied thereon does not exceed ten mills; but the property of the railroad company, in the same counties, is assessed at over one hundred per cent. of full value, and a rate of 16½ mills is levied upon that assessment. No fair-minded economist will justify such inequality. If, in the general assessment, through undervaluations and omissions from assessment, it results that the total valuation of the general property does not exceed thirty or fifty per cent. of value, that fact must have consideration in any logical or just administration of the *ad valorem* system. On the other hand, if income is made the test, a railroad is no more worth what it can earn than other property is worth what it can earn. If income is the most equitable measure of value, then pro-

vide an income tax that will reach the income value of all business enterprises alike.

CAN EQUALITY BE SECURED BY TAXING NET EARNINGS
DIRECT?

The law of Michigan which we are now considering provides for the ascertainment of what is denominated the "average rate" of taxation, by dividing the sum of the valuation of the general property of the state into the aggregate tax collected from the general property; and this so-called "average rate" is levied upon every railroad wherever located.

Is it not feasible to ascertain by investigation what is the true aggregate annual income of the general property of the state, and deduce therefrom the proportion of such income which, upon the average, is paid in taxes by the general property, and fix that as the rate which each railroad company shall pay upon its net receipts?

I am speaking now only of the economic, and not of the legal, aspect of the matter. Under the present system, we can draw from the general property, to compare with railroad property, no test except a local assessment, crude, contradictory, and made by the tax payers themselves, or by those whom they elect to office, from which is deduced what is called an "average rate", to be levied upon railroads at excessive estimates of value, derived from capitalizing their earnings at low rates.

Economists can surely devise methods for ascertaining the proportion of earnings paid in taxes by property in general and applying such rate to the net earnings of railroads, which will produce less inequality and injustice than grows out of such manifest maladministration of the *ad valorem* law.

If I do not misunderstand Professor Adams, he may

not dissent, in principle, from this view of broadening the income tax. Referring to certain manufacturing industries doing business under conditions which may secure to the proprietors a return considered in excess of the normal return, he says :

“The government retains the right to regulate prices, if need be, so as to extinguish any surplus value”.

He would doubtless be willing to add that the government, in addition to regulating the prices of such manufacturer, may also tax him, if need be, so as to extinguish any surplus value in his property.

Are economists ready to inaugurate this tax system for such industries? Take, for illustration, the banking industry. That capital employed in banking enjoys a much higher return than that invested in railroads, is well known ; and it therefore must be in excess of the normal. Shall government employ the taxing power as a means of extinguishing surplus value in the banks ?

It may be of comparatively little moment that owners of railroads protest against the application of these methods to their property, as a class, and to no other property ; but it is a matter of importance to us all to know whither we are tending.